Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:FS:LI:TL-N-1561-01
REGole

date: SEP 17 2001

to: Suzanne Boule
Technical Advisor, Financial Products

from: Associate Area Counsel (CC:LM:FS:LI)

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subject: Advisory Opinion Re: Letters of credit

This is in further response to your request for our advice in determining whether a standby letter of credit is a "security" within the meaning Of I.R.C. § 475(c)(2). In accordance with I.R.C. § 6110(k)(3) this Chief Counsel advice should not be cited as precedent. The National Office has indicated that it concurs with the advice rendered on September 5, 2001. However, in the last full paragraph on page 3 of our memorandum, we stated that a letter of credit "is best viewed as a security or an assurance." The reference to "security" in this paragraph is ambiguous and is intended to mean an "assurance" not a "debt".

We are closing our files at this time. If you have any questions, please call Rose Gole at (516) 688-1702. This issue presents a novel question of law requiring further development in a particular factual context.

Disclosure Statement

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

JODY TANCER
Associate Area Counsel
(Large and Mid-Size Business)

By: Rose E. Gole
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Attorney (LMSB)

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This is in response to your request for our advice in determining whether a standby letter of credit is a "security" within the meaning Of I.R.C. § 475(c)(2). In accordance with I.R.C. § 6110(k)(3) this Chief Counsel advice should not be cited as precedent. This issue presents a novel question of law requiring further development in a particular factual context. Pursuant to our August 24, 2001 telephone call, you advised our office that the taxpayer who originated this issue has not pursued this issue in this cycle. However since the issue presents a novel question under I.R.C. § 475, we have set forth our preliminary thoughts on this issue below.

DISCUSSION

I.R.C. § 475 was enacted by the Omnibus Budget Reconciliation Act of 1993 and requires dealers in securities to "mark to market" securities held at year-end. Securities, which are "marked to market," are deemed sold for fair market value at year-end. This results in the annual realization of gain and loss of readily marketable securities. I.R.C. § 475 was modified by the Taxpayer Relief Act of 1997 (securities traders and commodities dealers may elect to be covered by the mark to market rules) and subsequently the Tax Relief Extension Act of 1999 (definition of hedge transaction revised).

I.R.C. § 475(c)(2)(C) broadly defines the term "security" as any note, bond debenture or other evidence of indebtedness. You have questioned whether a standby letter of credit is an "other evidence of indebtedness." We are unaware of any authority which directly defines an indebtedness for purposes of I.R.C. § 475. However, the commentary we have read espouses a very broad definition of "indebtedness." For example, Peter J. Connors, Esq. and R. Arnold Handler, Esq. opine that:

> The scope of category C securities--notes, bonds, debentures, or other evidences of indebtedness--is sweeping. Other than "nonfinancial customer paper," category C securities encompass any evidence of indebtedness issued by any person in any context. For example, any bank loan, credit card receivable, trade receivable, or other informal extension of credit is a security under this definition.

"The Mark-To-Market Rules of Section 475," Tax Management Inc., p.40 (2001).

While we were unable to locate any authority on this issue, we note that the Service has issued a field service advice broadly defining "indebtedness" under the mark to market rules. The document stated that assuming the debt was valid, "accrued management fees and loans could possibly qualify as securities under subsection (c)(2)(C)" at least for years prior to July 22, 1998. FSA 199935024.[1]

If a letter of credit can be treated as an indebtedness, it is arguably within the purview of the mark to market rules. We believe that a letter of credit is not an indebtedness. "Letters of credit" are defined within federal and state case law. Article 5 of the Uniform Commercial Code sets a framework for defining a letter of credit[2]:

> "A letter of credit is an idiosyncratic form of undertaking that supports performance of an obligation incurred in a separate financial, mercantile, or other transaction or arrangement.

The intent of Article 5 is to "defin[e] the peculiar characteristics of a letter of credit" and "distinguish it from other forms of assurance such as secondary guarantees, performance bonds, and insurance policies, and from other ordinary contracts." U.C.C. § 5-101. Significantly the U.C.C. consider a letter of credit an "assurance" not an indebtedness.

Likewise, several Tax Court cases have defined letters of credit. For tax purposes, the letters of credit have not been

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[1] A field service advice is case specific and has no precedential effect, nor can it be relied upon as authority, in other cases.

[2] Most of the states have adopted the Uniform Commercial Code. However, the law of the applicable state should be considered.

treated as indebtedness. For example, the Tax Court concluded that a taxpayer could not accrued a deduction under I.R.C. § 461 based upon a letter of credit obtained in connection with the posting of an appeal of an adverse judgment. Concord Instruments Corporation v. Commissioner, T.C. Memo. 1994-248. The Tax Court cites Willamette Industries Inc. v. Commissioner, 92 T.C. 1116 (1989) as follows:

> When a bank issues a letter of credit, the bank commits to provide funds when and if certain specified events occur. It is not a loan, but rather a commitment to make a loan. Until the specified events occur, no money is transferred. (Citations omitted).

Supra. Also, Chase Manhattan Bank v. Equibank, 550 F.2d 882, 885 (3d Cir. 1977) For purposes of I.R.C. § 461, a letter of credit is treated by the Tax Court as a non-deductible contingent liability.

The District Court of Minnesota also denies a deduction under I.R.C. § 461 based on a letter of credit. Its opinion states that "A certified check is a cash equivalent but a letter of credit is similar to a consumer credit card waiting to be used." Chapman v. United States, 527 F. Supp. 1053 (U.S.D.C. Minn. 1981), citing White and Summers, Handbook of the Law Under the Uniform Commercial Code (1972) at 704-715.

The Tenth Circuit took a similar view of a letter of credit in Sprague v. United States, 627 F.2d 1044 (10th Cir. 1980). In Sprague, banks routinely drew on letters of credit as payment for outstanding debt. The Service argued that taxpayer constructively receives payments subject to the letters of credit. The Tenth Circuit rejected this view, finding that "the letters were mere security and were not to be routinely looked at for periodic payment." The Tenth Circuit holding is consistent with the treatment of a letter of credit as an assurance not a debt.

Based on the authority cited herein, we think the Service should take the position that an outstanding letter of credit is not an indebtedness and hence not a security within the meaning of I.R.C. § 475(c)(2). It is best viewed as a security or an assurance and the obligations thereunder. Since the obligations under a letter of credit are contingent, the letter does not have the characteristics of debt.

Although case law supports the finding that an outstanding letter of credit is not an indebtedness, a letter of credit may ripen into an indebtedness when it is accepted. Higgins v. Commissioner, 4 T.C. 1033 (1945). Moreover, treating a letter of credit as an indebtedness upon satisfaction is consistent with the

broad sweep of the mark to market rules. However, there would be a remaining issue as to who was the debtor. A letter of credit is unique insofar as the bank issuer has an unconditional obligation to honor a letter of credit in accordance with its terms. Hence, both the bank issuer, and the applicant are obligated on the letter of credit. Nevertheless, it is reasonable to conclude that for tax purposes, the liability under the letter is only an indebtedness of one of the participants.

We believe that the question of which participant is treated as having the indebtedness is factual and should be considered in the context of a particular case. However, there is limited precedent on this issue. For example, in Higgins, supra., the Tax Court concludes that while the Bank is obligated under the letter of credit, so too is the taxpayer and that the taxpayer is the one with the ultimate obligation to pay. Therefore, after the letter of credit ripened into an indebtedness, it was treated as an obligation of the taxpayer. We recommend that the issue of who incurs the indebtedness for an accepted letter of credit be considered at a later date in the context of a particular factual scenario.

As a final matter, we also draw your attention to I.R.C. § 475(c)(4)(A) which provides generally that "nonfinancial customer paper" is excluded from the definition of a security under I.R.C. § 475(c)(2). Nonfinancial customer paper is a receivable which is

1) a note, bond, debenture or other evidence of indebtedness;
2) arising out of the sale of nonfinancial goods or services by a person the principal activity of which is the selling or providing of nonfinancial goods or services; and
3) is held by such person (or a person who bears a relationship to such person described in section 267(b) or 707(b) at all times since issue.

I.R.C. 475(c)(4). This exception is intended largely to exempt taxpayers in nonfinancial services, routinely using receivables as securities from the mark to market rule. This exception may have some application to the same types of creditors that do business using letters of credit. Accordingly, it may be applicable.

We welcome your further input on this issue. In addition, please advise our office if this issue merits further development, including a field service advice, in a particular case.

You should be aware that, under routine procedures, which have been established for opinions of this type, we have referred this

opinion to the National Office for review. That review might result in modifications of the conclusions herein. We will inform you in writing of the result of the review as soon as we hear from the National Office. In the meantime, the conclusions reached in this opinion should be considered to be only preliminary. If you have any questions, please contact Rose Gole at (516) 688-1702.

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